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## Debt underwriting by commercial bank-affiliated firms and investment banks: More evidence

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### Abstract

We compare underwriting performance by commercial bank-affiliated firms (Section 20s) and traditional investment banks over the period 1995–1998. We find that gross spreads are lower in the case of Section 20 underwritings, but that yield spreads are not. Our sample includes a substantial number of observations following changes in Federal Reserve policies that substantially eased restrictions on Section 20 activities in early 1997. Our findings differ somewhat from results in the literature that focused on periods prior to these policy changes. We find, for example, no evidence that a prior commercial bank lending relationship influences underwriting yields for any type of issue. Our results also fail to confirm earlier evidence that collective Section 20 underwritings produce a favorable competitive effect on gross spreads and yield spreads. We find substantial evidence that both the underwriting mix and the underwriting process are relevant to the behavior of gross spreads and yield spreads over the sample period. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Commercial banking organizations have been heavily engaged in underwriting corporate securities issues in the 1990s, despite the apparent prohibition on such activities by the Glass–Steagall Act of 1933. Bank holding companies gained entry into the underwriting business when the Federal Reserve modified its interpretation of Section 20 of the Act which prohibits banks from being affiliated with any organization that is “engaged principally” in underwriting or dealing in securities. In 1986, the Fed permitted securities subsidiaries of bank holding companies to underwrite and deal in certain bank ineligible securities, provided that revenues from such underwritings constituted less than 5% of the subsidiary’s gross revenue.<sup>1</sup> The holding company subsidiaries that engage in such activities are commonly referred to as “Section 20 subsidiaries”.

In the interim, the Federal Reserve has enlarged the set of allowable underwritings and raised the allowable revenue limit. In 1989, the Fed permitted corporate bond underwriting and, in 1990, issues of equity securities. In January 1989, J.P. Morgan Securities underwrote the first public corporate bond issue by a commercial banking organization since the Glass–Steagall Act. In 1989, the Fed raised the revenue ceiling on ineligible underwritings to 10%. Effective in early 1997, the Fed again increased the limit to 25% and relaxed a set of restrictions (“firewalls”) on interactions between a Section 20 subsidiary and an affiliated bank. The Board eliminated restrictions on a bank engaging in marketing activities on behalf of an affiliated Section 20, loosened restrictions on interlocks between directors, officers and employees of a Section 20 subsidiary and an affiliated bank (which had been strictly prohibited), and eased constraints on the purchase and sale of financial assets between a Section 20 subsidiary and an affiliated bank. The amount of commercial bank-related underwritings has increased substantially in the late 1990s. During 1998, for example, three of the top 10 underwriters of US stocks and bonds by dollar volume were affiliated with bank holding companies (Salomon Smith Barney, JP Morgan, and Chase). As of June 1999, 51 Section 20 subsidiaries were owned by bank holding companies. Underwriting activities by commercial bank-related organizations are likely to increase further since the formal repeal of the Glass–Steagall Act by the Gramm–Leach–Bliley Financial Modernization Act of 1999.

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<sup>1</sup> The initial authority allowed underwriting and dealing in commercial paper, certain municipal revenue bonds, conventional residential mortgage-related securities, and securitized consumer loans. The set of securities that Glass–Steagall did not classify as ineligible for bank-related underwritings include US Treasuries, US agency securities, and general-obligation municipal securities.

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